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INFO RUEHRC/DEPT OF AGRICULTURE WASHINGTON DC
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RUMICEA/USCENTCOM INTEL CEN MACDILL AFB FL
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RUEHNE/AMEMBASSY NEW DELHI 4222
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SUBJECT: KARACHI STOCK EXCHANGE DROPPING WITHOUT FLOOR

¶1. (U) SUMMARY: Beginning Monday, December 15 the Government of Pakistan (GOP) required the country's three exchanges to remove a restriction ("floor") on trading below closing prices of August 27, ¶22008. The Karachi Stock Exchange (KSE) dropped approximately 4 percent during each of the first four days of trading, passing its lowest point since September 1, 2005. Analysts estimated the market has been overvalued by 40 percent. An exchange regulation that strictly limits the amount share prices can move each day has slowed the market decline but has also made finding fair market prices very difficult. Meanwhile, the GOP and the International Monetary Fund (IMF) finally reached consensus on a limited stock market support scheme of USD 250 million. END SUMMARY.

¶2. (SBU) On August 28, the KSE announced a trading restriction that prohibited listed shares from being traded below the closing price on August 27, following a plunge of 42 percent from the market's high on March 21. The "floor" on market prices effectively halted trading on the KSE although off-market, unregistered trading continued. Initially labeled a short "breathing space", after more than 100 days the floor is now described by the Pakistani press as the longest closing of a stock market in history. The Securities and Exchange Commission of Pakistan required the three exchanges of Pakistan to remove the trading floor as of Monday, December 15. The KSE dropped approximately 4 percent during each of the first four days of trading. After the tumble on December 18 the KSE hit its lowest point since September 1, 2005.

MARKETS WILL LIKELY CONTINUE TO RATCHET DOWN

¶3. (U) Despite these drops, the market still has not reached equilibrium. On the day the floor was removed the Karachi 100 Index traded at 9.9 times earnings, compared to the Morgan Stanley Core Index (MSCI) Emerging Markets Index's average of 8.3 times, making Pakistan Asia's fourth-most expensive market. Citibank analysts estimated the market was 40 percent overvalued at the time the floor was removed, and would decline to be closer to parity with other Asian markets. The MSCI AC Asia Pacific Index has fallen 31 percent since the floor was first imposed. On December 10, MSCI announced that Pakistan will be removed from the MSCI, effective December 31, which will force many index funds to sell Pakistani shares and further hurt Pakistan's equity market.

14. (SBU) KSE's Managing Director, Adnan Afridi, confirmed to EconOff that the KSE has not experienced a huge wave of panic selling because a "circuit breaker" mechanism is choking trade. He said that, following September 11, 2001, the KSE enacted a rule prohibiting the trading of stocks beyond a band of five percent above or below the opening day's share price. (Note: Bloomberg reports, and evidence suggests, that the rule actually permits stocks to decline 5 percent or 1 rupee, whichever is higher. End Note.) Afridi explained that the activity during the first days without the market floor were small trades (as little as 100 shares) to daily move the price down by the full amount permitted by the circuit breaker rule, and that trading will rapidly increase as shares approach competitive market valuations.

BAIL-OUT FUND

15. (U) Following the establishment of the market floor, many investors had hoped for a government bailout package designed to support stock prices. The GOP proposed two measures, the first would cost PKR 30 billion (USD 373 at 80.5 Pakistan rupees per USD) and entail offering foreign investors "put options", or the right to sell shares at a predetermined price. The second was a PKR 20 billion fund (USD 248 million), financed by private banks with a public guarantee, which would purchase shares of eight state-owned enterprises (SOE). As part of a USD 7.6 billion IMF program beginning November 24, Pakistan agreed to consult with the IMF before implementing any stock market support scheme.

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16. (SBU) On December 16, Pakistan announced it will establish the USD 250 million fund to buy listed SOE's shares after the market falls to its new equilibrium. IMF representatives had said they were opposed to the use of public funds to assist wealthy, private investors. However, the GOP revised the original proposal to eliminate the put-options fund and modified the SOE share-purchase fund so that it would not buy shares at above market prices selectively from some investors. IMF management remains reluctant, but the potential fiscal cost involved (a total of 0.2 percent of GDP distributed over a few years) is not large enough to be critical to macroeconomic stability.

FOREIGN PORTFOLIO INVESTMENT WILL DROP

17. (U) Financial analysts estimate that foreign portfolio investors have approximately USD 1.8 to 2.2 billion invested in Pakistani equity markets but that USD 500 million to 1 billion will be divested and expatriated now that the floor has been removed, draining scarce foreign exchange. Pakistan's two-year program agreement with the IMF loan agreement included an initial tranche of USD 3.1 billion. This infusion lifted foreign exchange reserves held by the SBP from USD 3.5 billion (less than one month's imports) to USD 6.01 billion as of December 15, but requires that the GOP maintains net foreign assets above predetermined levels to remain eligible for the remaining loan tranches. Huge outflows of foreign-owned assets will make it harder for the GOP to meet the IMF program performance criteria.

18. (U) COMMENT: As constructed, the circuit breaker causes stagnation in Pakistan's equity market. If such a safety mechanism is necessary, it should apply to an index rather than each individual company share price, and thereby protect the market from either euphoria or panic. The current formulation simply inhibits accurate pricing.

19. (U) COMMENT CONTINUED: The fund to purchase shares of SOEs is also poorly conceived. By interceding only after the market has reached its new equilibrium, the publicly guaranteed funds will have a negligible effect on market sentiment. Implementation of the support scheme looks increasingly like fulfillment of a promise by the ruling Pakistan People's Party to save political face. END COMMENT.

